

# Independent Auditor's Report





September 30, 1999

**INFORMATION MEMORANDUM**  
**S/S**

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TO: The Secretary  
FROM: *John C. Payton for* *Jacquelyn L. Williams-Bridgers*  
SUBJECT: Audit of the Department of State's 1997 and 1998  
Principal Financial Statements - Audit Report  
99-FM-031

SUMMARY

The Government Management Reform Act (GMRA) requires that the Office of Inspector General audit the agency's overall financial statements and submit its report to the head of the agency. Our opinion on the Department's 1997 and 1998 Principal Financial Statements is unqualified, which means the financial statements were free of material misstatement. However, our report brings to management's attention three significant internal control weaknesses and several instances of noncompliance with laws and regulations.

DISCUSSION

Consistent with GMRA requirements, a copy of our audit opinion on the Department's 1997 and 1998 Principal Financial Statements is attached. At the direction of my office, Leonard G. Birnbaum and Company, performed the audit.

The audit objective was to obtain reasonable assurance and express an opinion on whether the Principal Financial Statements were free of material misstatement. We are issuing an unqualified opinion on the 1997 and 1998 Principal Financial Statements. The report brings to management's attention concerns with security over the domestic main frame computers and the Paris Accounting and Disbursing System; the inadequacy of internal controls over the management of unliquidated obligations; and the inadequacy of the Department's financial

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and accounting system, which is both an internal control weakness and an issue of noncompliance with several laws and regulations, including the Budget and Accounting Act of 1950, the Federal Managers' Financial Integrity Act, the Chief Financial Officers Act, and the Federal Financial Management Improvement Act. We also bring to management's attention noncompliance with the GMRA that requires agencies to prepare audited financial statements and submit them to the Office of Management and Budget by March 1 of each year.

The Bureau of Financial Management and Policy (FMP) agreed with our findings and conclusions, and its comments are included as appendix A to the report. In addition to this report, we will be sending a separate management letter, prepared by our contractor, to FMP discussing several minor matters that were identified during the audit.

We are pleased with the improvements that the Department has made in financial management since the CFO Act was passed in 1990. However, a number of improvements still need to be made, as described in the report. We also believe that the Department should devote adequate resources to financial statement preparation to ensure that it can issue audited financial statements by March 1.

We appreciate the cooperation extended to us by the Department's managers and staff during the audit.

Attachments:

Tab 1 -- Audit Report 99-FM-031

cc: FMP - Mr. Bert T. Edwards

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**INDEPENDENT AUDITOR'S REPORT**

To the Secretary, Department of State:

We have audited the Department of State's (Department) Consolidated Balance Sheet, Consolidating Statement of Net Cost, Consolidated Statement of Changes in Net Position, Combined Statement of Budgetary Resources, Statement of Financing, and Statement of Custodial Activity (Principal Financial Statements) as of and for the year ended September 30, 1998, and have examined internal control over financial reporting in place as of September 30, 1998. We also audited the Department's 1997 Principal Financial Statements, consisting of its Consolidated Statement of Financial Position and Consolidated Statement of Operations and Changes in Net Position as of, and for the year ended, September 30, 1997, and expressed an unqualified opinion on them.

In our opinion, the Department's 1998 Principal Financial Statements are presented fairly in all material respects.

We found:

- no material conflicts with the Department's 1998 report on management controls, prepared under the Federal Managers' Financial Integrity Act of 1982, which cites the financial and accounting system and information systems security as material weaknesses, and
- instances, as noted below, of noncompliance with selected provisions of applicable laws and regulations.

Each of these conclusions is discussed in more detail below. This report also discusses the scope of our work.

## PRINCIPAL FINANCIAL STATEMENTS

In our opinion, the Department's 1998 Principal Financial Statements, including the notes thereto, present fairly, in all material respects, the Department's financial position as of September 30, 1998, and the net cost of operations, the changes in net position, the use of budgetary resources, and the use of financing resources for the year then ended, on the basis of accounting described in Note I to the Principal Financial Statements.

As described in Note 1, the Department prepares its Principal Financial Statements in conformity with the hierarchy of accounting principles and standards approved by the Federal Accounting Standards Advisory Board. This hierarchy is a comprehensive basis of accounting other than generally accepted accounting principles.

This report incorporates the results of our separate audits of the financial statements of the Foreign Service Retirement and Disability Fund (FSRDF) which, as of September 30, 1998, comprised over 55 percent of the Department's assets and 80 percent of its liabilities, and the financial statements of the International Cooperative Administrative Support Services (ICASS) program. Audits of FSRDF's and ICASS' statements as of, and for the years ended, September 30, 1997, and 1998, resulted in unqualified opinions.

Office of Management and Budget (OMB) Bulletin 97-01, *Form and Content of Agency Financial Statements*, requires presentation, as supplementary information, the disaggregation of the Statement of Budgetary Resources for each of the Department's major budget accounts. The Department has not provided this data. However, this omission does not affect our opinion on the Department's Principal Financial Statements.

Amendments to OMB Bulletin 98-08, *Audit Requirements for Federal Financial Statements*, provide that, when information related to deferred maintenance is presented in the notes to the financial statements, the auditor is not expected to audit such information. With respect to the information presented in Note 21, Deferred Maintenance, we have applied certain limited auditing procedures including discussions with management on the methods of measurement and presentation of the supplemental information. However, we did not audit the information and therefore express no opinion on it.

## INTERNAL CONTROL

We considered the Department's internal control in order to determine our auditing procedures for the purpose of expressing our opinion on the Principal Financial Statements and not to provide assurance on internal control.

The objectives of internal control are to provide management with reasonable, but not absolute, assurance that the following objectives are met:

- transactions are properly recorded and accounted for to permit the preparation of reliable financial reports and to maintain accountability over assets;
- funds, property, and other assets are safeguarded against loss from unauthorized acquisition, use, or disposition;
- transactions, including those related to obligations and costs, are executed in compliance with laws and regulations that could have a direct and material effect on the financial statements and other laws and regulations that OMB, Department management, or the Inspector General have identified as being significant for which compliance can be objectively measured and evaluated; and
- data that support reported performance measures are properly recorded and accounted for to permit the preparation of reliable and complete performance information.

Our consideration of internal control would not necessarily disclose all matters of internal control that might be material weaknesses under standards established by the American Institute of Certified Public Accountants and OMB Bulletin 98-08.

Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of internal control that, in our judgement, could adversely affect the Department's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. A material weakness is a reportable condition in which the design or operation of one or more of the specific internal control elements does not reduce to a relatively low level the risk that errors or irregularities in amounts, which would be material in relation to the financial statements being audited or material to a performance measure or aggregation of related performance measures, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

We noted the following matter that we consider to be a material weakness as defined above. The Department's main frame computers for domestic operations are considered vulnerable to unauthorized access; consequently, other systems, including the Department's financial management systems, which process data using these computers, may also be vulnerable. Similar access control weaknesses were found in the Paris Financial Service Center's Accounting and Disbursing System.

We noted two matters involving internal control that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants and OMB Bulletin 98-08. These are described in the following two paragraphs.

The Department's financial and accounting system, as of September 30, 1998, was inadequate. The principal areas of inadequacy were:

- certain elements of the financial statements including real property, personal property, capital improvements, and capital leases are developed from sources other than the general ledger;
- some fund balances with Treasury, principally from earlier years, as reported on the Department ledgers were not reconcilable with balances reported by Treasury, the Department's records reflect \$112 million less than the corresponding Treasury balances, a difference that is not considered material;
- certain accounts payable general ledger balances were not reconcilable with the accounts payable detail;
- financial statements were not issued on a timely basis; and
- unliquidated obligation balances were significantly inaccurate, requiring substantial manual effort to correct.

The Department's internal control process related to the management of unliquidated obligations was inadequate. This included unsupported obligations and the lack of a structured process to reconcile and deobligate funds in a timely manner. For example, a review of \$103 million of unliquidated obligations that had no activity during fiscal year 1998 disclosed that 48 percent, or \$50 million, should have been deobligated. A majority of the \$50 million was related to obligations over 1 year old.

We noted certain other internal control issues that we have reported to the Department's management in a separate letter dated August 9, 1999.

### COMPLIANCE WITH LAWS AND REGULATIONS

The Department's management is responsible for complying with laws and regulations applicable to the Department. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of the Department's compliance with certain provisions of laws and regulations, noncompliance with which could

have a direct and material effect on the determination of financial statement amounts, and certain other laws and regulations specified in OMB Bulletin 98-08, including the requirements referred to in the Federal Financial Management Improvement Act (FFMIA) of 1996. However, the objective of our audit of the Principal Financial Statements, including our tests of compliance with selected provisions of applicable laws and regulations, was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

Material instances of noncompliance are failures to follow requirements or violations of prohibitions in statutes and regulations that cause us to conclude that the aggregation of the misstatements resulting from those failures or violations is material to the financial statements or that sensitivity warrants disclosure thereof

The results of our tests of compliance with the laws and regulations described in the preceding paragraph disclosed the following instances of noncompliance with laws and regulations that are required to be reported under *Government Auditing Standards* and OMB Bulletin 98-08.

- The inadequacies of the Department’s financial management systems are a failure to comply with:
  - the Budget and Accounting Procedures Act of 1950, which requires an accounting system that provides full disclosure of the results of financial operations, adequate financial information needed in the management of operations and the formulation and execution of the budget, and effective control over income, expenditures, funds, property, and other assets;
  - the Federal Managers’ Financial Integrity Act (FMFIA) of 1982, which requires implementation of internal accounting and administrative controls that provide reasonable assurance that (1) obligations and costs are in compliance with applicable laws, (2) funds, property, and other assets are safeguarded against waste, loss, unauthorized use, or misappropriation, and (3) revenues and expenditures applicable to Department operations are properly recorded and accounted for to permit the preparation of accounts and reliable financial and statistical reports and to maintain accountability over the assets;
  - the Chief Financial Officers Act of 1990, which requires the development and maintenance of an integrated accounting and financial management system that (1) complies with applicable accounting principles, standards and requirements, and internal control standards, (2) complies with such policies and requirements as may be prescribed by the Director of OMB,



(3) complies with any other requirements applicable to such systems, and (4) provides for (i) complete, reliable, consistent, and timely information that is prepared on a uniform basis and that is responsive to the financial information needs of agency management, (ii) the development and reporting of cost information, (iii) the integration of accounting and budgeting information, and (iv) the systematic measurement of performance;

- OMB Circular A- 127, *Financial Management Systems*, which requires the Department to establish and maintain an accounting system that provides for (1) complete disclosure of the financial results of the activities of the Department, (2) adequate financial information for Department management and for formulation and execution of the budget, and (3) effective control over revenue, expenditure, funds, property, and other assets; and
- the Government Management and Reform Act of 1994, which requires the heads of designated executive agencies to prepare and submit to the Director of OMB an audit of financial statements by March 1, covering the preceding fiscal year.

The results of our tests of compliance with other laws and regulations disclosed no material instances of noncompliance. Compliance with FFMIA is discussed below.

Under FFMIA, we are required to report whether the Department's financial management systems substantially comply with the Federal financial management system requirements, applicable accounting standards, and the United States Standard General Ledger at the transaction level. To meet this requirement, we performed tests of compliance using the implementation guidance for FFMIA issued by OMB on September 9, 1997.

The results of our tests disclosed instances, described below, where the Department's financial management systems did not substantially comply with the requirement to follow the Federal financial management system requirements. OMB implementation guidance states that, to be in substantial compliance with this requirement, the Department must (1) meet Circular A-127 requirements, including the requirement to support management's fiduciary responsibility, (2) follow requirements published in *JFMIPs Federal Financial Management System Requirements* series, and (3) comply with Circular A-130, Appendix III, *Security of Federal Automated Resources*. We found the following instances of substantial noncompliance with these three standards.

- Circular A-127 requires that the Department's systems support management's fiduciary role by providing complete, reliable, consistent, timely and useful financial management information. Based on the weaknesses related to financial management systems discussed in the report on internal control and the preceding paragraphs in the report on compliance, we determined that the Department was not substantially in compliance with this standard.
- JFMIP's *Federal Financial Management System Requirements* state that the core financial management systems must support the partnership between program and financial managers and assure the integrity of decisionmaking information including the ability to collect accurate, timely, complete, reliable, and consistent information. JFMIP also requires that the core financial system be able to provide financial information to support internal and external reporting requirements, including as necessary the requirements for financial statements. OMB guidance states that one indicator of compliance with this standard is that the Department's core financial system, supported by other systems containing the detailed data summarized in the core financial system, be the source of information for the preparation of the annual financial statements. However, the Department's core financial system is not the sole source of information used in the preparation of the annual financial statements. Based on these issues, we determined that the Department did not substantially comply with this standard.
- Circular A-130, Appendix III, requires that the Department assure an adequate level of security for all agency automated information systems, specifically, the Department shall assure that automated information systems operate effectively and assure that there are appropriate safeguards in the automated information systems. Based on our concerns related to the financial management systems discussed in the report on internal control and the preceding paragraphs in the report on compliance, we determined that the Department was not substantially in compliance with this standard. Circular A-130 also requires that the Department assure the continuity of operations of automated information systems that support critical agency functions. However, we found that the Department had not established a complete contingency/business recovery plan for its Central Financial Management System.

The Department's Bureau of Financial Management and Policy has overall responsibility for the Department's financial management systems. The foregoing noncompliance has its roots in the overall lack of organization and integration of the Department's financial management systems. This issue has been highlighted in the Department's annual FMFIA report since 1983. In our audit of the Department's 1997 Principal Financial Statements, we observed that the Department's financial management systems were not in compliance with FFMIA and

recommended that a remediation plan be prepared. Although the Department reported its noncompliance with FFMIA to OMB on January 28, 1999, it has not prepared a remediation plan that includes the resources, remedies, and intermediate target dates necessary to bring the Department's financial management systems into substantial compliance. Since the law states that an agency's remediation plan should bring the financial management systems into substantial compliance with FFMIA within 3 years of the date that the agency determined that its financial management systems did not comply with the requirements of the FFMIA (January 28, 1999 in this case), we believe the Department should dedicate the necessary resources to develop a remediation plan expeditiously.

We noted certain other instances of noncompliance that we will be reporting to the Department's management in a separate letter dated as of August 9, 1999.

### RESPONSIBILITIES AND METHODOLOGY

Department management has the responsibility for:

- preparing the Principal Financial Statements in conformity with the comprehensive basis of accounting described in Note I to the Principal Financial Statements;
- establishing and maintaining an effective internal control structure; and
- complying with applicable laws and regulations.

Our responsibility is to express an opinion on the Principal Financial Statements based on our audit. Generally accepted auditing standards require that we plan and perform the audit to obtain reasonable assurance about whether the Principal Financial Statements are free of material misrepresentation and presented fairly in accordance with the basis of accounting described in Note I to the Principal Financial Statements. We considered the Department's internal control for the purpose of expressing our opinion on the Principal Financial Statements referred to above and not to provide an opinion on internal control. We are also responsible for testing compliance with selected provisions of applicable laws and regulations that may materially affect the financial statements.

In order to fulfill these responsibilities, we

- examined, on a test basis, evidence supporting the amounts and disclosures in the financial statements;

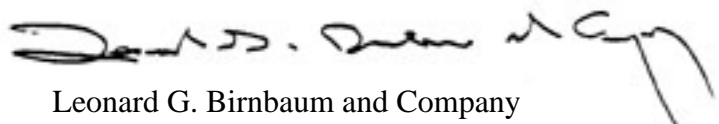
- assessed the accounting principles used and significant estimates made by management;
- evaluated the overall presentation of the Principal Financial Statements;
- obtained an understanding of internal control over financial reporting;
- tested compliance with selected provisions of laws and regulations that may materially affect the financial statements; and
- performed other procedures as we considered necessary in the circumstances.

Our audits were conducted in accordance with generally accepted auditing standards, the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, and OMB Bulletin 98-08. We believe that our audits provide a reasonable basis for our opinion.

The Overview contains a wide range of data. Professional standards require the auditor to read this information and consider whether this information, or the manner of its presentation, is materially inconsistent with the information, or the manner of its presentation, in the financial statements. If the auditor concludes that there is a material inconsistency, the auditor should determine whether the financial statements or the other information require revision. We found no inconsistencies between data contained in the *Overview* and corresponding data contained in the financial statements.

This report is intended for the information of the Inspector General of the U.S. Department of State and the Department's management. This restriction is not intended to limit the distribution of this report, which is a matter of public record.

Comments by the Department's management on this report are presented as Appendix A.



Leonard G. Birnbaum and Company

Alexandria, Virginia  
August 9, 1999



United States Department of State

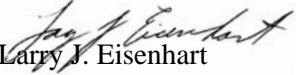
Deputy Chief Financial Officer

Washington, D.C. 20522-1506

MEMORANDUM

SEP 24 1999

TO: OIG/AUD - Mr. M. M. MacDonald

FROM: FMP/F -  Larry J. Eisenhart

SUBJECT: Draft Audit Report on the Department of State's Consolidated Statement of Financial Position for Fiscal Year 1998

This is in response to your request for comments on the draft audit report titled "Department of State's Consolidated Financial Statements for Fiscal Year 1998." In relation to internal control, the report cites the Department's computer access controls as a material weakness and two reportable conditions: (1) the inadequacy of the Department's financial management systems and (2) the inadequacy of the management of the unliquidated obligation process. In addition, the Department's financial management systems have been reported as noncompliant with laws and regulations, including the Federal Financial Management Improvement Act of 1996 (FFMIA).

As we noted last year, it is our understanding that although access to the mainframe computer was obtained during the review of the Department's computer security, the contractor and the GAO auditors did not access the financial system (CFMS) software. To ensure that adequate controls are in place in CFMS, we contracted with a CPA firm experienced in doing FISCAM-type reviews. Development of policies, procedures, CFMS security awareness training and a recurring evaluation process are almost complete.

The weaknesses in the Department's financial management systems are a long-standing problem. The Department continues its improvement initiatives, including preparation of a remediation plan as required by the FFMIA. As provided for by OMB guidance, the Department will soon submit the remediation plan as part of its supplemental financial management information to the FY 2001 budget. To strengthen management of unliquidated obligations, we continue to develop reports and procedures to use in reviewing obligations.

We thank you for the opportunity to comment on the draft report and for working with us in a collaborative manner on the FY 1998 financial statements. We believe that we have worked constructively with your office over the past several years and that considerable progress has been achieved. The Department is committed to continuing its efforts to improve management of its programs and the quality of its financial reporting. If you have any questions concerning our response to the audit report, please contact Christopher H. Flaggs, Managing Director, Domestic Financial Services, on (703) 875-7141.